IN THE

# Supreme Court of the United States,

OCTOBER TERM, 1924—No. 80.

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THE UNITED STATES OF AMERICA,
*Petitioner,*

—against—

EDWARDS H. CHILDS, Trustee in Bankruptcy of J. Menist Company, Inc.

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## *ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.*

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Court Press, N. Y. C. Bowling Green, 2820

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## *RESPONDENT'S BRIEF.*

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## POINT I.

**The Government is not entitled to interest upon its claim for taxes after the filing of the petition in bankruptcy.**

Section 57-j of the Bankruptcy Act, which provides for the manner of the payment of obligations due the United States, reads as follows:

> "Debts owing to the United States, a State, a county, a district or a municipality as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction,

> or proceeding out of which the penalty or forfeiture, arose, with reasonable and actual costs occasioned thereby and *such interest as may have accrued thereon according to law.*"

The Government contends taxes are not debts. The courts, however, have passed upon this specific question and have held that taxes are regarded as debts under the Bankruptcy Act.

> *In re Sherwoods*, 210 Fed. Rep. 254, 258;
> *Kaw Boiler Works* v. *Schull*, 230 Fed. Rep. 587, 589.

Since taxes are regarded as debts under the Bankruptcy Act, can the Government claim any interest after the date of the filing of the petition in bankruptcy?

This Court has held that the United States is bound by the Bankruptcy Act.

> *Guarantee Co.* v. *Title Guaranty Co.*, 224 U. S. 152;
> *U. S. Fidelity Co.* v. *Bray*, 225 U. S. 205;
> *United States* v. *Wood*, 290 Fed. 109 (affd. 163 U. S. 680).

After comparing the provisions of the Acts of 1867 and 1898 and indicating other changes, Mr. Justice McKenna in *Guarantee Co.* v. *Title Guaranty Co.*, *supra*, at page 160, says:

> "The act (of 1898) takes into consideration, we think, the whole range of indebtedness of the bankrupt, national, state and

individual, and assigns the order of payment."

In the determination of the question as to whether Federal taxes bear interest, not only must Section 14-a of the Revenue Act be read in conjunction with Section 57-j of the Bankruptcy Act, as argued by the Government, but Section 63-a of the Bankruptcy Act must likewise be considered.

Section 63-a of the Bankruptcy Act provides:

> "Debts of the bankrupt may be proved and allowed against his estate which are (1) a fixed liability as evidenced by a judgment or an instrument in writing, absolutely owing at the time of the filing of the petition against him, whether then payable or not, *and with any interest thereon which would have been recoverable at that date* or with a rebate of interest upon such as were not then payable and did not bear interest."

Debts do not bear interest after the filing of the petition in bankruptcy.

*Sexton* v. *Dreyfus*, 219 U. S. 339.

In *Sexton* v. *Dreyfus*, *supra*, Mr. Justice Holmes says, on page 344:

> "For more than a century and a half the theory of the English bankrupt system has been that everything stops at a certain date. Interest was not computed beyond the date of the commission. *Ex parte Bennet*, 2 Atk. 527. This rule was applied to mortgages as well as to unsecured debts; *Ex parte Wardell*, 1787; *Ex parte Hercy*, 1792, 1 Cooke, Bankrupt Laws, 4th ed. 181;

(1st ed., Appendix), and notwithstanding occasional doubts, it has been so applied with the prevailing assent of the English judges ever since. *Ex parte Badger*, 4 Ves. 165. *Ex parte Ramsbottom*, 2 Mont. & Ayrt. 79. *Ex parte Penfold*, 4 De G. & Sm. 282. *Ex parte Lubbock*, 9 Jr. N. S. 854. *In re Savin*, L. R. 7 Ch. 760, 764. *Ex parte Bath*, 22 Ch. Div. 450, 454. *Quartermaine's Case* (1892), 1 Ch. 639. *In re Bonacino*, 1 Manson, 59. As appears from *Cooke*, *supra*, the rule was laid down not because of the words of the statute but as a fundamental principle. We take our bankruptcy system from England, and we naturally assume that the fundamental principles upon which it was administred were adopted by us when we copied the system, somewhat as the established construction of a law goes with the words where they are copied by another State. *No one doubts that interest on unsecured debts stops.* See Sec. 63 (1). *Board of County Commissioners* v. *Hurley*, 169 Fed. Rep. 92, 94."

Section 57-j of the Bankruptcy Act provides for the payment of "such interest as may have accrued thereon according to law." What other law could have been intended other than the law that a debt bears interest until the date of the filing of the petition in bankruptcy? The rule is not only logical but equitable. Assuming a tax had been duly assessed against a bankrupt whose estate consists wholly of a number of choses in action, is the Government's claim for taxes to increase continuously by the accrual of interest to the detriment of general creditors while the trustee is endeavoring to realize on the assets?

The Bankruptcy Act contemplates equality

among creditors while recognizing the Government's preference for taxes. Can it logically be argued that a proper construction of this Act contemplates that not only shall the Government have a preference of the principal of its claim but that pending the administration of an estate there should be permitted to accrue in favor of the Government an additional preference for interest upon its tax claim while the claims of general creditors remain *in status quo?*

In the case of *Swarts* v. *Hammer,* 194 U. S. 441, the referee allowed a tax bill together with accrued penalties and fees provided by law.

On review the District Court affirmed the order as to the amount of the taxes, but disapproved it as to penalties or fees. It does not appear that exception was taken to that portion of the order disallowing penalties and fees. Neither the Court of Appeals nor the Supreme Court was called upon to consider that question.

## POINT II.

### If the Government is entitled to interest on its claim until paid the rate of interest should not be more than 6% per annum.

Under Section 6407 of the United States Compiled Statutes, if a plaintiff secures a judgment against the United States and the Secretary of the Treasury asserts a set-off, any balance found to be payable by the United States over and above the lawful set-off bears interest at six per cent.

Mr. Justice White in *Sun Printing Ass'n* v. *Moore*, 183 U. S. 672, held that where there is an excessive disproportion between the sum due and the possible damages resulting from a breach, the question of disproportion is an element entering into the consideration of whether the parties intended to fix the damages or to stipulate the payment of an arbitrary sum as a penalty.

There has been some conflict of authority on this question, but we submit that the reasoning in *Re Ashland, Emery & Corundum Co.*, 229 Fed. Rep. 829, which was followed by both the District Judge and the Circuit Court of Appeals, is sound in principle and a proper interpretation of the Bankruptcy Act.

In that case the Court said, at page 831:

> "If the charge here in controversy is to be regarded as interest, the trustee ought to pay it. Penalties, however, stand upon a different footing. It cannot be said that a penalty imposed for failure to pay a tax, is part of the original tax, in the sense that interest is. By 'interest' is ordinarily understood a charge for the use of money or damages for the detention of it. A penalty, as applied to cases of this character, means a punishment imposed for failure to make the payment on time. Section 64-a contains no provision for the payment of penalties; and I do not think it can fairly be construed to include them, especially when, as here, the estate was in course of administration during the entire period when they accrued."

And again, at page 832:

> "Assuming, however, that it is, it seems to me plain, and I accordingly find, that 1% a month exceeds what is fairly required to make good a loss to the state for mere delay in the payment of the tax, and as to such excess is not interest, but constitutes a penalty imposed for failure to pay promptly. The actual damages sustained by the State of New Jersey from the delay are not obscure nor difficult to estimate. What the state lost was the use of the money. Its damages, therefore, are the commonest form known to the law, and the most certain of estimation. They are established by statute in New Jersey for individuals at 6% per annum."

In the case of *New York* v. *Jersawit*, 263 U. S. 493, the case involved the construction of the statute of the State of New York which provides for the payment of delinquent tax of 10% of said amount, plus 1% for each month the tax remains unpaid. Mr. Justice Holmes in writing the unanimous opinion of the Court, says, on page 496:

> "There can be no doubt that the additional ten per centum charged for failure to pay by January 1, is a penalty, disallowed by the Bankruptcy Act, Sec. 57-j, but it is urged that the one per centum for each month of default is statutory interest and that the State is entitled to that and otherwise would be entitled to none. As the one per centum is more than the value of the use of the money and is added by the statute to the ten to make a single sum it must be treated as part of one *corpus* and must fall with that. We presume that in this event the State does not object to receiving the simple interest allowed."

The Government contends that in *New York* v. *Jersawit, supra*, the wording of the New York Statute did not designate 1% as interest; but from the opinion of this Court it appears that the State of New York contended in its argument before this Court, that the 1% per month for the default in the payment of the tax is a statutory interest. This Court, however, held that it was in the nature of a penalty.

*In re Clark Realty Co.*, 253 Fed. Rep. 938, involved a claim by the holder of tax sales certificates wherein the claimant was endeavoring to recover the rate of interest allowed by the law of the State of Wisconsin for the redemption of property sold for taxes. The Court held that the claimant was entitled only to 6% per annum.

*In re Dayton, trustee, etc.* v. *Standard Treasurer of Pueblo County, Colorado*, 241 U. S. 588, the controversy arose out of a sale for taxes on real property belonging to a bankrupt estate then in the course of administration in a Court of Bankruptcy. Mr. Justice Van Devanter, on page 590, says:

> "And while we are of opinion that the certificate holders were entitled to interest upon the amounts paid at the ordinary legal rate, applicable in the absence of an express contract, we think they were not entitled to the larger interest required to be paid on redemption from tax sales."

The conclusion therefore is inescapable that in the absence of proof of pecuniary loss by the United States Government interest at the rate of

1% per month is a penalty within the language of Section 57-j of the Bankruptcy Act and is not an allowable claim.

## *POINT III.*

***The judgment of the Circuit Court of Appeals should be affirmed.***

Respectfully submitted,

MOSES COHEN,
*Attorney for Respondent.*